Supreme Court, U.S.
FILED
OCT 24 2003
OFFICE OF THE CLERK

No. 02-1016

In the Supreme Court of the United States

LEE M. TILL AND AMY M. TILL,

Petitioners,

v.

SCS CREDIT CORPORATION,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF AMICUS CURIAE FOR COMMERCIAL LENDERS IN SUPPORT OF RESPONDENT

JAMES C. SCHROEDER
Counsel of Record
STUART M. ROZEN
MICHAEL A. SCODRO
Mayer, Brown, Rowe & Maw LLP
190 South LaSalle Street
Chicago, Illinois 60603
(312) 782-0600

Counsel for amici curiae

TABLE OF CONTENTS

Page

INTEREST OF THE AMICI CURIAE 1

SUMMARY OF ARGUMENT 2

ARGUMENT 4

I. The Bankruptcy Code Entitles A Secured Creditor To A Schedule Of Future Payments That The Creditor Could Market Today For The Value Of Its Collateral 4

II. Using The Market Rate Of Interest Is Consistent With *Rash* 8

III. Finding The Fair Market Rate Is Typically Straightforward 9

A. Chapter 11 9

B. Chapter 13 12

C. The Contract Rate 13

IV. Petitioners' Proposed "Prime-Plus" Rate Has No Basis In The Statute And Systematically Under-compensates Secured Creditors 14

A. Petitioners Start From The Demonstrably False Premise That There Is No Risk Of Nonpayment In Bankruptcy 16

TABLE OF CONTENTS-Continued

Page

B. Petitioners Erroneously Presume That Lenders In A Competitive Market Enjoy Economic Profits 20

C. Petitioners Ask The Court To Presume Away Transaction Costs 22

V. Petitioners' Approach Would Have Harmful Consequences 23

CONCLUSION 24

TABLE OF AUTHORITIES

Cases: **Page**

Associates Commercial Corp. v. *Rash*, 520 U.S. 953 (1997) ..... *passim*

Bank of America Nat'l Trust & Sav. Ass'n v. *203 North LaSalle Street Partnership*, 526 U.S. 434 (1999) ... 21

Bloomingdale Partners, In re, 155 B.R. 961 (Bankr. N.D. Ill. 1993) 6

Cassell, In re, 119 B.R. 89 (W.D. Va. 1990) 19, 20, 22

Cellular Info. Sys., Inc., In re, 171 B.R. 926 (Bankr. S.D.N.Y. 1994) 10, 12, 22

Commissioner v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974) 15

Deluca, In re, 1996 WL 910908 (Bankr. E.D. Va. Apr. 12, 1996) 10, 12

General Motors Acceptance Corp. v. *Jones*, 999 F.2d 63 (3d Cir. 1993) 19, 22

Hardzog, In re, 901 F.2d 858 (10th Cir. 1990) 11, 13

Johnson v. *Home State Bank*, 501 U.S. 78 (1991) 4

TABLE OF AUTHORITIES-Continued

Page

Jones & Laughlin Steel Corp. v. *Pfeifer*, 462 U.S. 523 (1983) 15

Kane v. *Johns-Manville Corp.*, 843 F.2d 636 (2d Cir. 1988) 18

Kidd, In re, 315 F.3d 671 (6th Cir. 2003) 16

Koopmans v. *Farm Credit Services*, 102 F.3d 874 (7th Cir. 1996) 20

Rake v. *Wade*, 508 U.S. 464 (1993) 5

Rash, In re, 90 F.3d 1036 (5th Cir. 1996), rev'd, 520 U.S. 953 (1997) 23

Valenti, In re, 105 F.3d 55 (2d Cir. 1997) 17

Weiss, In re, 251 B.R. 453 (Bankr. E.D. Pa. 2000) 18

Statutes:

11 U.S.C. § 361 18

11 U.S.C. § 506 9

11 U.S.C. § 506(a) 5, 8

11 U.S.C. § 1129 ..... 7, 9

11 U.S.C. § 1129(b)(2) 4, 5, 7, 8, 9

TABLE OF AUTHORITIES-Continued

Page

11 U.S.C. § 1325 ..... 7, 9

11 U.S.C. § 1325(a)(5) 4, 5, 7, 8, 9

Miscellaneous:

Nancy R. Baldiga, *Is This Plan Feasible? An Empirical Legal Analysis of Plan Feasibility*, 101 COM. L.J. 115 (1996) 18

Richard A. Brealey & Stewart C. Myers, PRINCIPLES OF CORPORATE FINANCE (5th ed. 1996) 6, 11

Steven N. Bulloch, *Shareholder Agreements in Closely Held Corporations: Is Sterilization an Issue?*, 59 TEMP. L.Q. 61 (1986) 11

7 COLLIER ON BANKRUPTCY (15th ed. rev. 2003):
¶ 1129.06[1][b] 6
¶ 1129.06[1][c][iii] 17

Ed Crooks, *Bank's Chief Economist Casts Doubt on Rate Rise*, FIN. TIMES, Oct. 2, 2003, at 2 9

David G. Epstein, *Don't Go and Do Something* Rash *About Cram Down Interest Rates*, 49 ALA. L. REV. 435 (1998) 11

Joseph A. Franco, *The Investment Company Act's Definition of "Security" and the Myth of Equivalence*, 7 STAN. J.L. BUS. & FIN. 1 (2001) 6

TABLE OF AUTHORITIES-Continued

Page

Patrick Halligan, *Cramdown Interest, Contract Damages, and Classical Economic Theory*, 11 AM. BANKR. INST. L. REV. 131 (2003) 21

Steven Miller, *The Development of the Leveraged Loan Asset Class* in BANK LOANS: SECONDARY MARKET AND PORTFOLIO MANAGEMENT 1 (Frank J. Fabozzi ed., 1998) 6

Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees & Exclusivity*, 6 BANKR. DEV. J. 1 (1989) 12

Evan Perez, *Lennar Net Soars as Low Rates Lift Housing Industry*, WALL ST. J., June 11, 2003, at A6 9

THE 2003 BANKRUPTCY YEARBOOK & ALMANAC (Christopher M. McHugh ed., 2003) 2

Michael H. Whitaker, Note, *Regulating Claims Trading in Chapter 11 Bankruptcies: A Proposal for Mandatory Disclosure*, 3 CORNELL J.L. & PUB. POL'Y 303 (1994) 6

Todd J. Zywicki, *Cramdown and the Code: Calculating Cramdown Interest Rates Under the Bankruptcy Code*, 19 THURGOOD MARSHALL L. REV. 241 (1994) 19, 20, 21, 22, 23

INTEREST OF THE AMICI CURIAE[1]

Amici curiae are institutions (together, "Commercial Lenders") that collectively loan billions of dollars annually to commercial entities. Amici are:

Allstate Life Insurance Company
Bank of America
Bank of Montreal
The Bank of New York
Barclays Bank PLC
Bear, Stearns & Company
Deutsche Bank Trust Company Americas
Fernwood Associates, LP
General Electric Capital Corporation
Highland Capital Management LP
Lampe, Conway & Co. LLC
Morgan Stanley Prime Income Trust
PPM America
Tennenbaum Capital Partners
Van Kampen Investment Advisory Corporation

The Commercial Lenders typically secure these loans with collateral. It is common for companies to use their assets to secure millions of dollars in financing. For example, companies may obtain the funds needed for day-to-day operations by taking out a loan on a hotel, office building, or other piece of commercial real estate. Other businesses use their plants, equipment, or accounts receivable as collateral. In any of these instances, commercial lenders become secured creditors in the event of bankruptcy.

---

[1] Pursuant to Rule 37.3 of the Rules of this Court, the parties have consented to the filing of this brief. The parties' letters of consent have been lodged with the Clerk. This brief was not authored, in whole or in part, by counsel for any party, and no person or entity other than the amici curiae and their counsel made any monetary contribution to the preparation or submission of the brief.

The parties to this brief participate routinely as secured creditors in Chapter 11 reorganizations. Large Chapter 11 cases frequently involve creditors' claims totaling tens of millions or hundreds of millions of dollars. In 2002 alone, Chapter 11 bankruptcies were filed by 114 public companies each having assets of more than $100 million. THE 2003 BANKRUPTCY YEARBOOK & ALMANAC 44-47 (Christopher M. McHugh ed., 2003).

This case requires the Court to interpret language in Chapter 13 of the Bankruptcy Code, but substantially equivalent language applies to secured creditors in Chapter 11 cramdowns (cases in which a plan of reorganization is confirmed over the objections of secured creditors). See *infra* p. 4. Petitioners urge the Court to apply the Code's language atextually and in a manner that does not provide lenders with the present value of their secured claims. Ensuring that secured creditors receive the protections to which they are entitled under the Code is critical to the Commercial Lenders' business operations.

SUMMARY OF ARGUMENT

Where a debtor seeks to confirm a plan of reorganization that has not been accepted by a secured creditor, the Bankruptcy Code requires that the secured creditor receive under the plan future payments from the debtor that equal, in present value terms, the market value of the collateral securing the creditor's claim. The Court is now asked to decide what it means to say that a series of promised, future payments has a particular value as of the plan's effective date. The answer to this question necessarily determines the interest rate the debtor must pay on the secured creditor's allowed secured claim in order to ensure that the payments provided for under the plan permit the secured creditor to receive the required value as of the plan's effective date. Consistent with the Court's decision in *Associates Commercial Corp.* v. *Rash*, 520 U.S. 953 (1997),

the market provides a clear answer to this question. A creditor's right to future payments from the debtor is currently worth whatever price that right would command on the open market. The creditor's right to future payments under a "cramdown" plan thus has a present value equal to the market value of its collateral—as the Code requires—only if the reorganization plan requires the debtor to make the payments at the interest rate it would have to pay on a loan obtained for the same amount on the open market on the plan's effective date.

In the commercial lending market, with which the Commercial Lenders are intimately familiar, determining the market rate of interest on a loan to any particular borrower is a straightforward exercise. Lenders in competitive financial markets consider putative borrowers' individual risk profiles and set commensurate interest rates every day. In the context of a cramdown plan of reorganization in Chapter 11 where, by definition, parties do not agree on an interest rate, lenders can—and regularly do—submit evidence concerning what rate the market would offer a borrower with the profile of the debtor as reorganized under its proposed bankruptcy plan.

Rather than even attempt to approximate a market rate of interest, however, petitioners propose to set the interest rate under nonconsensual plans of reorganization based on a "formula" that they admit would do little more than compensate creditors for the time value of money and that therefore fails to afford the secured creditor value equal to the market value of its collateral. This formula is not only inconsistent with *Rash* and without any basis in the Bankruptcy Code, it arises from a series of erroneous presumptions. Petitioners wrongly assume, for example, that their calculus does not need to account for the debtor's individual risk profile because all or nearly all risk of non-payment disappears in bankruptcy. Petitioners also proceed from the erroneous presumption that lenders in a competitive market enjoy economic profits that must be eliminated in arriving at present value for cramdown purposes. Based on

these and other threshold errors, petitioners define "value" in a wholly artificial manner that systematically undercompensates secured creditors by ignoring statutory text, this Court's jurisprudence, and market reality.

ARGUMENT

I. The Bankruptcy Code Entitles A Secured Creditor To A Schedule Of Future Payments That The Creditor Could Market Today For The Value Of Its Collateral.

One of three things must be true of each secured claim in bankruptcy before the court can confirm a Chapter 13 plan: either "the holder of such claim has accepted the plan"; "the debtor [has] surrender[ed] the property securing such claim to such holder"; or the secured creditor has retained its lien on the collateral "securing such claim" and "*the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim.*" 11 U.S.C. § 1325(a)(5) (emphasis added). It is this last, italicized requirement—"designed to protect Chapter 13 creditors," *Johnson* v. *Home State Bank*, 501 U.S. 78, 87 (1991)—that the Court is asked to interpret here. Chapter 11 contains essentially the same provision; it requires that a secured creditor "receive * * * *deferred cash payments totaling at least the allowed amount of such claim, of a value,* as of the effective date of the plan, *of at least the value of such holder's interest* in the estate's interest in such property." 11 U.S.C. § 1129(b)(2)(A)(i)(II) (emphasis added).

Before the italicized language comes into play, however, a bankruptcy court must determine the "allowed amount" of a secured claim—which this Court has held must be determined based on the market value of the underlying collateral when the debtor proposes to retain possession and control of the collateral. See *Associates Commercial Corp.* v. *Rash*, 520 U.S. 953, 960-965 (1997); *infra* pp. 8-9. If the debtor is going to retain possession of the collateral, §§ 1129(b)(2) and 1325(a)(5)

thus ensure that whatever "property" the creditor is scheduled to receive "under the plan" has a value "not less than" the collateral's current market price.[2] There is near universal agreement—and the parties to this case do not dispute—that this provision guarantees the secured creditor "property" under the plan with a "present value" of no less than the market value of its collateral. See *Rash*, 520 U.S. at 957; see also *Rake* v. *Wade*, 508 U.S. 464, 469 (1993) ("§ 1325(a)(5)(B)(ii) guarantees that property distributed under a plan on account of a claim, including deferred cash payments in satisfaction of the claim * * * must equal the present dollar value of such claim as of the confirmation date"). The "property" a creditor usually receives under a bankruptcy plan is the debtor's promise to make specified payments over time. At issue here is the interest rate the debtor must pay on an allowed secured claim so that this promise of future payments has a "value" to the secured creditor on the plan's effective date equal to the collateral's market value on that date.

The financial markets allow us to know with reasonable certainty what a promise of future payments is worth today. "[T]he value, as of the effective date of the plan, of property [*i.e.*, the right to payments] to be distributed under the plan," 11 U.S.C. § 1325(a)(5), is necessarily the price that the property would fetch on the open market as of the plan's effective date. See *Rash*, 520 U.S. at 960 (the "value of the property" is "the price a willing buyer * * * would pay to obtain like property

---

[2] The secured creditor is not entitled to the full present value of the collateral if the creditor is oversecured—*i.e.*, if the collateral is worth more than the creditor's secured claim. In that case, the creditor only has a legal interest in a share of the collateral's value, and the creditor is entitled to property under the plan with a present value no less than the market price of that share. See 11 U.S.C. §§ 506(a), 1129(b)(2)(A)(i)(II). But where, as in this case, a secured creditor in bankruptcy is undersecured, it is entitled to future payments under the plan equal to the present value of the collateral as a whole.

from a willing seller"). Accordingly, the debtor's plan must require the debtor to pay the full amount of the creditor's allowed secured claim plus interest at a rate sufficient to allow the creditor to sell its right to the future payments, on the effective date, for a lump sum equal to the amount of its allowed secured claim. See *In re Bloomingdale Partners*, 155 B.R. 961, 977 n.13 (Bankr. N.D. Ill. 1993) ("if the interest rate proposed were adequate, [the creditor] would be able to sell its claim [to future payments] for at least [the present value of its collateral]"); Richard A. Brealey & Stewart C. Myers, PRINCIPLES OF CORPORATE FINANCE 12 (5th ed. 1996) ("the present value of [a] property is also its market price"); see also 7 COLLIER ON BANKRUPTCY ¶ 1129.06[1][b], at 145 (15th ed. rev. 2003) (providing numerical example). The government, in fact, acknowledges that "the value of plan payments depends on their estimated worth in financial markets," and that there should be "a direct, fair market appraisal of the risk-adjusted present value of future payments." U.S. Br. 8. 9. Thus, if a payment schedule provides a creditor holding an allowed secured claim of $1,000 with future payments having a present value of $1,000, the creditor will be able to find a buyer willing to pay $1,000 for the rights to those payments.[3]

---

[3] There is a well-developed "secondary market for trading loans." Joseph A. Franco, *The Investment Company Act's Definition of "Security" and the Myth of Equivalence*, 7 STAN. J.L. BUS. & FIN. 1, 18 n.49 (2001); see also Steven Miller, *The Development of the Leveraged Loan Asset Class* in BANK LOANS: SECONDARY MARKET AND PORTFOLIO MANAGEMENT 1, 3, 7 (Frank J. Fabozzi ed., 1998). Indeed, "[s]everal trade organizations and service entities exist dedicated to" this market. Franco, *supra*, 7 STAN. J.L. BUS. & FIN. at 18 n.49. Likewise, "[t]rading in claims of bankrupt concerns" is a "multi-billion dollar market." Michael H. Whitaker, Note, *Regulating Claims Trading in Chapter 11 Bankruptcies: A Proposal for Mandatory Disclosure*, 3 CORNELL J.L. & PUB. POL'Y 303, 303 (1994).

The only interest rate that would allow for such an exchange is the market rate of interest the debtor would have to pay to obtain a new loan in the amount of the allowed secured claim, payable over the period provided for in the plan. To continue the above example, lenders in the market would give the debtor $1,000 today in exchange for a security interest in collateral worth $1,000 and a promise to repay the loan at a market-set rate of interest. Lenders in the market would likewise be willing to pay a *creditor* (instead of the debtor) $1,000 in exchange for the same lien and the same promise from the debtor to repay the $1,000 at the same market-set rate. But if the interest rate is set at below-market rates for a loan to the debtor, the stream of promised payments could not be sold for $1,000—a willing buyer would pay less than that—and thus the "value" of the promised payments will be less than "the allowed amount" of the secured creditor's claim, in contravention of §§ 1129(b)(2) and 1325(a)(5).

This is not to say that the market rate of interest on a new loan to the debtor is the proper interest rate in cramdown because it reflects the secured creditor's "opportunity cost"—*i.e.*, the amount the creditor could make if it received the $1,000 today and lent it to another borrower. Indeed, if the creditor were free to find another borrower, it may well be able to loan the money at a higher interest rate. Rather, a market interest rate that is tied to the reorganized debtor's particular circumstances reflects the reality that each loan has its own risk profile and, accordingly, its own required market rate of interest. The rate at which *the debtor could borrow* an amount equal to the allowed secured claim is dictated by the market, and payment of this rate is required in order to provide the secured creditor with property of a value, as of the plan's effective date, equal to the allowed amount of its secured claim—as §§ 1129 and 1325 provide.

II. Using The Market Rate Of Interest Is Consistent With *Rash*.

As noted above, 11 U.S.C. §§ 1129(b)(2) and 1325(a)(5) entitle secured creditors in a cramdown plan to the present value of the "allowed amount" of their secured claim in bankruptcy. This "allowed" amount, in turn, is determined based upon "the *value* of [the] creditor's interest in the estate's interest in such property." 11 U.S.C. § 506(a) (emphasis added). The question before this Court in *Rash* was the proper measure of the "value" of the creditor's interest in collateral. The Chapter 13 debtors in that case had purchased a tractor truck before filing for bankruptcy. The debtors had purchased the truck on credit, and at the time of their bankruptcy petition they still owed $41,171 to Associates Commercial Corporation ("ACC"), which had been assigned both the loan and the seller's lien on the vehicle. 520 U.S. at 956.

The debtors argued that § 506(a) limited ACC's secured claim to the truck's foreclosure value—the $31,875 net amount that the debtors' expert said ACC would likely receive if it foreclosed on the truck and sold it at auction. *Rash*, 520 U.S. at 957. ACC argued that its allowed secured claim was equal to the vehicle's replacement value—the $41,000 that ACC's expert said it would cost the debtor to purchase such a truck on the market today. *Ibid.* The Court sided with ACC, holding that when the debtor retains its ownership interest in property "the value of the property * * * is the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller." 520 U.S. at 960. In other words, the allowed amount of a secured claim is determined based on the collateral's current, "fair-market value." *Id.* at 959 n.2.

The Court in *Rash* thus analyzed "value" in § 506(a) in terms of the collateral's "fair market" price—the price of exchange between a "willing buyer" and a "willing seller." "Value" should have the same meaning in §§ 1129(b)(2) and

1325(a)(5). The current "value" of promised, future payments is the price at which a willing buyer would purchase the rights to those future payments today. Providing a secured creditor with any less than a right to future payments marketable for the fair price of its collateral would deny the creditor the "value" it is entitled to receive under *Rash*.

This reading of "value" in § 1325(a)(5) is not only consistent with the definition the Court assigned the same term elsewhere in the Code; it is the only reading consistent with *Rash*. In practice, an item's "fair market value" always depends, at least in part, on the financing terms accompanying that price. A "willing buyer" will pay more for an item if the interest rate is favorable. The most recent example of this economic truism is the fact that low interest rates have allowed home sellers to obtain higher sales prices for homes.[4] The two features of the sale—price and payment terms—are inseparable, something even petitioners acknowledge. See Pet. Br. 46-47. Having decided that "value" in § 506 is the collateral's market price, it follows that the proper discount rate to use in §§ 1129 and 1325 is the market interest rate that accompanies that price.

III. Finding The Fair Market Rate Is Typically Straightforward.

A. Chapter 11

The government implicitly agrees that the proper benchmark for the cramdown discount rate is the market rate available for a new loan to the debtor. U.S. Br. 16 n.7. The

---

[4] See, *e.g.*, Evan Perez, *Lennar Net Soars as Low Rates Lift Housing Industry*, WALL ST. J., June 11, 2003, at A6 (explaining that "low interest rates" enabled home builder "to sell more homes at higher prices"); Ed Crooks, *Bank's Chief Economist Casts Doubt on Rate Rise*, FIN. TIMES, Oct. 2, 2003, at 2 (listing "low interest rates" among "reasons for the long-term level of house prices to be higher").

government contends, however, that, "unlike the market for automobiles that provided the basis for the replacement-value calculation in *Rash*[,] there is no directly analogous 'market' for discount rates that reflects the unique mix of" factors "that exist in bankruptcy." *Ibid.* That is certainly not correct in the Chapter 11 context: developed national and international commercial financing markets make it relatively easy to determine the rate on a new loan to a borrower with the reorganized debtor's risk profile.

As a general proposition, market rates of interest are determined based on the risk associated with a particular loan. The greater the collateral value relative to the loan amount—*i.e.*, the more the collateral cushion—the lower the interest rate because the creditor's risk of nonpayment is protected to a greater degree against risks both in the borrower's economic fortunes and in the downward fluctuation of the collateral. In the commercial context, where the value of the collateral is equal to the amount of the secured loan, financial markets have longstanding methods for calculating rates. The market generally provides financing in tiers of debt and equity, with the more senior (*i.e.*, less risky) tiers bearing lower rates. This is known as the "investment band" approach. Thus, for example, a borrower seeking to obtain financing in an amount equal to 100% of the market value of the property it owned might receive a loan for an amount equal to 80% of its property on a secured basis. This loan would be oversecured by the collateral as a whole and would accordingly be available at a lower interest rate. The remaining 20% of the financing might then be a combination of junior debt—either unsecured or secured by a junior lien and, therefore, far riskier and at a much higher rate of interest—and an equity interest in the borrower. See, *e.g.*, *In re Deluca*, 1996 WL 910908, at *14-15 (Bankr. E.D. Va. Apr. 12, 1996) (relying on investment band analysis); *In re Cellular Info. Sys., Inc.*, 171 B.R. 926, 943-944 (Bankr. S.D.N.Y. 1994) (same); David G. Epstein, *Don't Go and Do Something* Rash *About Cram Down Interest Rates*, 49 ALA. L.

REV. 435, 464 (1998) (describing use of "investment band" method "to hypothesize the loans that the debtor could obtain in the market place").

The specific rates the market sets for these layers, or "bands" of financing, depends heavily on the borrower's individual risk profile. Banks and other commercial lenders consider an array of borrower characteristics in deciding whether to loan and what interest rate to charge. Lenders generally examine the borrower's credit record, financial statements, stock performance, marketing materials, average bank balance, and the quality of its management team in the hopes of estimating the company's projected growth, the strength of its competition, and the future of the industry as a whole. Steven N. Bulloch, *Shareholder Agreements in Closely Held Corporations: Is Sterilization an Issue?*, 59 TEMP. L.Q. 61, 77 n.120 (1986) (compiling sources and summarizing "factors with which creditors are concerned in making lending decisions"); Brealey & Myers, *supra*, at 852-853 (listing factors to consider in deciding whether customer is a likely credit risk); see also *In re Hardzog*, 901 F.2d 858, 860 (10th Cir. 1990) (listing some of the "host of * * * factors" that lenders consider in setting an interest rate). Lenders may rely in part on leverage, liquidity, profitability, and market value ratios as tools in this process. Brealey & Myers, *supra*, at 766, 853. Each industry, and each business within that industry, has unique characteristics making it more or less risky. Professional lenders assess those characteristics and set a rate commensurate with the particular borrower's overall risk of non-payment.

In Chapter 11 cases, all of this information can be—and is—the subject of evidence, sometimes in the form of expert testimony, offered by the parties. Having considered evidence about the rates available to the reorganized debtor for different tiers of financing, a court would merely need to calculate the weighted average of the various market rates to set an overall discount rate that, as applied to the payment stream contem-

plated by the plan, would provide the secured creditor with property having a value as of the effective date equal to its allowed secured claim. See, *e.g.*, *Deluca*, 1996 WL 910908, at *15 (performing weighted average to calculate "blended rate"); *Cellular Info. Sys.*, 171 B.R. at 944 (rejecting debtor's proposed plan because its cramdown interest rate was below weighted average of rates applicable to investment bands available in the market).

B. Chapter 13

Analogous evidence concerning the debtor's specific risk profile could be offered in Chapter 13 cases where the parties do not agree on an interest rate. (Because an individual's finances are much simpler than a business's, the evidence would not need to be as elaborate as that offered in a business reorganization case under Chapter 11.) The court could then determine a market rate of interest for a loan to the debtor that, as applied to the secured creditor, would afford the secured creditor the present value required by the Code. Petitioners suggest that the market for "subprime" consumer loans is not competitive and cannot serve as the basis for fair discount rates in bankruptcy. Pet. Br. 16 n.14, 17. But there is no reason to think that this segment of the American economy is immune from competition. In any event, nothing prevents the debtor from arguing to the bankruptcy court that suggested market rates are overstated in a particular case based on the debtor's credit/risk profile as the debtor is reorganized under its bankruptcy plan.

Petitioners warn that requiring bankruptcy courts to consider case-specific information to set cramdown rates would burden the courts with evidentiary hearings. See Pet. Br. 9 n.7, 23. But parties usually agree on the discount rate to apply to secured creditors under a bankruptcy plan. See, *e.g.*, Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKR. DEV. J. 1, 8 n.17 (1989). Typically, there is no need for the court to hear evidence and set a rate. Moreover, where the parties cannot agree, bankruptcy courts are already required to hold hearings concerning the collateral's market value to determine the amount of the creditor's allowed secured claim. See *Rash*, 520 U.S. at 965 n.6 ("leav[ing] to bankruptcy courts, as triers of fact, identification of the best way of ascertaining replacement value on the basis of the evidence presented"). Indeed, gauging the market interest rate for a borrower with the debtor's risk profile is likely to be much easier and less time consuming than formulating a risk premium out of whole cloth, as petitioners propose, which would also require evidentiary hearings. See, *e.g.*, *Hardzog*, 901 F.2d at 860 ("Courts are not well situated to craft and determine interest rates" but "are well equipped to determine market rates").

C. The Contract Rate

Petitioners and their *amici* spend much of their time challenging the Seventh Circuit's presumption that the parties' contract rate of interest is the appropriate rate in cramdown. The Commercial Lenders agree that the statute does not require any such formal presumption. Market rates may have shifted dramatically, or the debtor's risk profile may have changed, since the parties entered into their contract.

But while the contract rate should not be determinative, it is relevant. The contract reflects an interest rate to which a willing borrower and a willing lender agreed on the open market. It reflects the market's take on the borrower's specific risk profile at a point in time. Things may have changed since the parties negotiated their contract—and these changes are the proper subject of proceedings before the bankruptcy court—but the contract rate is potentially an important piece of evidence. We thus agree fully with the district court in this case, which in deciding for the respondent set an interest rate based on "what the market [would] bear." Pet. App. 36a. The debtor's post-

bankruptcy credit/risk profile warranted application of the rate dictated by the sub-prime market, and the court cited "unrebutted evidence * * * that a sub-prime market exists and that its rate is 21%." *Id.* at 38a. "The fact that the contract rate is 21% [was] not controlling [on the] Court's decision. * * * [W]hat [was] controlling is the market rate." *Ibid.* The district court properly set the discount rate at 21% not because it was the contract rate, but because it was the current market rate for a borrower with the debtor's risk profile. To allow a lower rate in such circumstances would necessarily result in the secured creditor receiving less than the Code requires—property with a value equal to the amount of the allowed secured claim on the plan's effective date.

IV. Petitioners' Proposed "Prime-Plus" Rate Has No Basis In The Statute And Systematically Undercompensates Secured Creditors.

Petitioners urge the Court to adopt a "prime-plus" or "formula" approach to the discount rate. They espouse a rule in which courts begin (and often end) with a riskless rate of interest and, if necessary, add a modest risk premium, usually less than 1% and never to exceed 3%. Pet. Br. 45-49.

One fundamental problem with this method is that it has utterly no textual basis in the statute. A range of 10%-30%, or 100%-300%, would have the same grounding in the text of the Bankruptcy Code: none.

Another basic problem with petitioners' "formula" approach is that it makes no effort at all to predict what the market would actually do, although a focus on the market is inherent in any determination of the "value" of property. On the contrary, petitioners propose a "'present value' analysis" that does little more than compensate "'for the changing value of a

dollar.'" Pet. Br. 21.[5] Petitioners contend that the prime rate will often be the proper discount rate in bankruptcy and that—if creditors receive any compensation for risk above what the prime rate affords—it should be no more than 1% to 3%. *Id.* at 46. In addition to having no basis in the language of the Code, such a crabbed reading of "value" is patently inconsistent with this Court's reliance on market value in *Rash*. Indeed, petitioners recommend their "formula" only by presuming away nearly every element of the free market interest rate.

---

[5] Petitioners thus invoke this Court's decisions in *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974), and *Jones & Laughlin Steel Corp.* v. *Pfeifer*, 462 U.S. 523 (1983), where the "Court has previously examined discounting to present value in other contexts." Pet. Br. 26-27. Petitioners cite these cases for the "limited function of the present value concept" that they describe—a concept meant merely to adjust for "the prevailing market rate for money" and for the "rate of interest [obtainable] on the best and safest investments" using "present value tables standard in the financial community." *Id.* at 27 (emphasis omitted). But these decisions are inapposite. *National Alfalfa* involved "debt discounting"—where debentures are sold below their face amount and the difference in price is treated like interest on debt for income tax purposes. 417 U.S. at 147-155. The case had nothing to do with "discounting" future income streams based on the risk of nonpayment. *Jones & Laughlin Steel* required the Court to determine the proper amount of a one-time award meant to compensate the plaintiff for lost future wages. The Court reduced the award because the plaintiff had a "duty to mitigate" his damages by investing the award at the "best and safest" investment rate. 462 U.S. at 537-538 & n.20. Once again, the case had nothing to do with discounting future income based on the risk of nonpayment.

A. Petitioners Start From The Demonstrably False Premise That There Is No Risk Of Nonpayment In Bankruptcy.

First, and most remarkably, petitioners make the conclusory assertion that the cramdown rate should ignore *all debtor-specific risk data*. "Petitioners contend that, in order to restore a level of uniformity appropriate to a national system of bankruptcy laws, courts must return to the historic concept of discounting to present value, which does not rely upon fact-specific characteristics of the creditor or debtor." Pet. Br. 42; see also *id.* at 9. Petitioners press for a "payment stream discounted to reflect the present value of the 'allowed secured claim' in a fixed amount, without any additional creditor-debtor fact-based considerations." *Id.* at 18. They thus rely heavily on the Sixth Circuit's decision in *In re Kidd*, 315 F.3d 671 (6th Cir. 2003), particularly language in that opinion equating the Chapter 13 cramdown rate with "'the current conventional market rate used for similar loans in the region'"—which "'does not entail an analysis of any particular debtor's credit rating but rather involves a more objective determination of the value of money over time.'" Pet. Br. 39 (emphasis omitted). Petitioners' position, and the language from *Kidd* on which petitioners rely, flies in the face of the plain language of the Code, this Court's jurisprudence, and common sense.

As the government recognizes, a rule that ignores debtor-specific risk factors would be a nonsensical legal fiction.[6] The

---

[6] The government recognizes the "virtues" of an approach that accounts for "the case-specific risk of nonpayment"—an assessment "that the bankruptcy court is uniquely competent to make." U.S. Br. 12. The government accordingly advocates a rate that reflects "the risk-adjusted market value of capital." *Id.* at 24. The government correctly concludes that inclusion of such a "case-specific risk" factor in the cramdown rate is consistent with *Rash*, which "adopt[ed] the replacement value as the measure of the collateral" in part because

lending market relies heavily on factors specific to the borrower and its industry in setting an interest rate. See *supra* p. 11. If the idea is to account for the real risks faced by the creditor, as it must be given the statutory requirements for cramdown in both Chapters 13 and 11, then the court must be free to consider any and all facts bearing on that risk. See 7 COLLIER ¶ 1129.06[1][c][iii], at 151 (courts should "assess the riskiness of the loan in relation both to the market for similar loans and the debtor's particular risk profile"). Ultimately, it is because petitioners never recognize that a discount rate "formula" is only as good as its capacity to mimic a competitive market that they do not see the utter arbitrariness of divorcing their formula from the debtor-specific risk factors on which the market most heavily relies.

At times, petitioners reluctantly acknowledge the need for a risk premium in certain cases but seek an arbitrary limit on that premium of between 1%-3%. Foreordaining a risk range is as arbitrary as the practice—squarely rejected by this Court in *Rash*—of splitting the difference between foreclosure and replacement values in appraising collateral. See 520 U.S. at 964 ("Whatever the attractiveness of a standard that picks the midpoint between foreclosure and replacement values, there is no warrant for it in the Code"). The 1% to 3% range comes from *In re Valenti*, 105 F.3d 55 (2d Cir. 1997). Pet. Br. 46. But the *Valenti* court created that range for no reason other than the fact that its "review of the caselaw * * * suggests that the risk premium has been set by bankruptcy courts at from one to three percent." 105 F.3d at 64 (citing three cases). There was no effort in *Valenti* to approximate the rate that a free and competi-

---

"'[a]djustments in the interest rate' may not be enough to account for case-specific risks of nonpayment and depreciation of collateral." *Id.* at 12 n.5. In the end, however, the government deviates from a market-based approach to endorse a "prime-plus" formula that would simply "reflect the time value of money." *Id.* at 7-8.

tive market would offer the debtor if it wished to borrow the value of its collateral today.[7]

Underlying petitioners' effort to eliminate (or arbitrarily cabin) the courts' ability to account for the risk of nonpayment is the misguided belief that many "nonbankruptcy market-risk factors are * * * eliminated under Chapter 13." Pet. Br. 45. Petitioners specifically cite the fact that the bankruptcy court must conclude that the plan is feasible, that the debtor must make numerous disclosures, and that the creditor has the right to seek "adequate protection under 11 U.S.C. § 361" and "payment by wage assignment orders." *Id.* at 45-46. Petitioners also note that the debtor will restructure its unsecured debt and that a creditor can "seek dismissal of the case in the event of a material default." *Id.* at 46.

As this Court recognized in *Rash*, however, the "'vast majority of reorganizations fail.'" 520 U.S. at 963; see also Brief for U.S. as *Amicus Curiae* Supporting Petitioner 26, *Associates Commercial Corp.* v. *Rash*, No. 96-454 ("the majority of Chapter 13 plans fail"). The "feasibility" determination is not a demanding one,[8] and in any case is no more than a "prediction[] of future events that might not come true." *In re*

---

[7] Even the government concedes that "the risk factor element under a prime-plus approach may need to be larger than some courts have suggested." U.S. Br. 16 n.7.

[8] See, *e.g.*, *In re Weiss*, 251 B.R. 453, 467 (Bankr. E.D. Pa. 2000) ("the feasibility requirement is generally not rigorous"); see also *Kane* v. *Johns-Manville Corp.*, 843 F.2d 636, 649 (2d Cir. 1988) ("the feasibility standard [asks] whether the plan offers a reasonable assurance of success. Success need not be guaranteed"). One study showed that even among cases in which feasibility was challenged and the court expressly found that the plan was feasible, "half of the confirmed, nonliquidating plans did not fully consummate." Nancy R. Baldiga, *Is This Plan Feasible? An Empirical Legal Analysis of Plan Feasibility*, 101 COM. L.J. 115, 130 (1996).

Cassell, 119 B.R. 89, 92 (W.D. Va. 1990). As for the creditor's right to adequate protection, this right only exists before the plan is confirmed. And it "is not always vindicated" even then. *Ibid.*; see *id.* at 92-93 ("Enforcing the right often requires the creditor to expend substantial time and funds in vigilantly monitoring the claim and the collateral so that it may take timely action to protect itself. There is no guarantee that the creditor will receive adequate protection even if it seeks such protection in a timely manner and the bankruptcy court takes timely action").

This Court properly recognized in *Rash* that secured creditors in bankruptcy are actually "exposed to double risks: The debtor may again default and the property may deteriorate from extended use." *Id.* at 962; see *id.* at 963 (because most reorganizations fail, creditors are left "'with only a fraction of the compensation due them'"). Indeed, even if certain circumstances do decrease the risk, "[o]ther factors will tend to increase" it. Todd J. Zywicki, *Cramdown and the Code: Calculating Cramdown Interest Rates Under the Bankruptcy Code*, 19 THURGOOD MARSHALL L. REV. 241, 260 (1994). "For instance, the collateral for the original loan probably provided an equity cushion to protect against depreciation. Because the loan to value ratio for a cramdown loan is one to one, there is no equity cushion." *Ibid.*; see also *Cassell*, 119 B.R. at 92 ("since the loan is for 100 percent of the collateral's value, one might say the bank's risk is greater than before"); *General Motors Acceptance Corp.* v. *Jones*, 999 F.2d 63, 68 (3d Cir. 1993) (observing that "loans coerced in cramdown proceedings are frequently loans without an 'equity cushion'").[9]

In any event, the answer to the parties' dispute over the general risk to creditors in bankruptcy is not to ignore debtor-

---

[9] As described above (at pp. 10-11), "investment band" financing provides a market rate even for loans where the loan-to-value ratio is one-to-one.

specific risk factors and arbitrarily prescribe some narrow interest range that is not grounded in the text of the Bankruptcy Code and diverges from market realities, as petitioners propose. Rather, the bankruptcy court should consider debtor-specific facts and set a rate that accounts for whatever risk exists in a particular case—just as the market would—and thereby give the secured creditor future payments with a present value equal to the creditor's claim, as the Code requires.

B. Petitioners Erroneously Presume That Lenders In A Competitive Market Enjoy Economic Profits.

The second basis for petitioners' arbitrary and under-compensatory discount rate formula is the misperception that market interest rates include inappropriate "profits" that bankruptcy creditors should not enjoy. In fact, the market for corporate and other commercial financing is a model of competition. "Financial intermediation is today highly competitive. Money is fungible and flows across the globe; local lenders package and sell their loans on national and international markets in order to attract fresh capital." *Koopmans* v. *Farm Credit Services*, 102 F.3d 874, 876 (7th Cir. 1996). As a result, "profits," as petitioners use the term, do not exist. *Ibid.* (in a competitive market, "[w]hat appears on the books as accounting profit is just the opportunity cost of keeping the firm's assets in this business rather than the next-best alternative"); see also *Cassell*, 119 B.R. at 92 ("the profit component of the market rate is properly considered part of the cost of capital").

The accounting "profits" that appear on the balance sheet of lenders in a competitive market are "indistinguishable from the normal return on capital without which loans will not be made." Zywicki, *supra*, 19 THURGOOD MARSHALL L. REV. at 261. It is "the real interest component of the market rate," and is accordingly "considered part of the cost of capital." *Ibid.*; see also Patrick Halligan, *Cramdown Interest, Contract*

Damages, and Classical Economic Theory, 11 AM. BANKR. INST. L. REV. 131, 162 (2003) ("Ordinary markups or profits really are just a component of cost, namely, of the cost of capital"). Now-Professor Zywicki explains:

> "Profit" is actually the cost of deferring present consumption until a later time, and the tradeoff within a creditor's business between alternative methods of financing. Even if payment was guaranteed and inflationary expectations were zero, the real interest rate would still be positive, because it reflects "the price required to induce a lender to effect an exchange between current and future consumption." Thus, there is no "profit" from enticing deferred compensation.

Zywicki, *supra*, 19 THURGOOD MARSHALL L. REV. at 261 (footnotes omitted). This "profit" is included even in a risk-free rate like the Treasury rate, and no one disputes that this return should be included in the "present value" discount rate. Indeed, *Rash* ensured that creditors were entitled to this form of "profit" by requiring that the allowed amount of the secured claim be based on the value of the collateral at its fair market price. In order to assure that the creditor receives this value under a cramdown plan, the statute requires that the payments provided for in the plan include a market rate of interest.

C. Petitioners Ask The Court To Presume Away Transaction Costs.

Finally, petitioners erroneously presume that the market lending rate will include various transaction costs that the creditor would not incur in bankruptcy. In commercial financing in Chapter 11 cases, however, these costs are trivial in comparison to the overall amount of the secured claim and have little effect on the interest rate. See, *e.g.*, *Bank of America Nat'l Trust & Sav. Ass'n* v. *203 North LaSalle St. P'ship*, 526 U.S. 434, 440 (1999) (bank had $54.5 million secured claim); *Cellular Info.*

Sys., 171 B.R. at 929 (banks had $94.5 million secured claim). And any such costs are likely to wash out in any event. Administering a loan to a debtor in bankruptcy has its own unique costs. See Zywicki, *supra*, 19 THURGOOD MARSHALL L. REV. at 259 ("It is doubtful * * * that there will be any net decrease in administrative costs when a secured claim becomes a cramdown claim in bankruptcy"). Accordingly, "[w]hile some administrative costs will already have been incurred, and thus saved, * * * the 'legal, managerial, and clerical costs in monitoring and accounting' for a bankruptcy claim will at least offset these savings." *Ibid.* As one court observed, "a creditor almost certainly incurs legal, managerial, and clerical costs in monitoring and accounting for a Chapter 13 claim that are not present in a standard loan situation. Rather than being less, it appears to the court that there is a good chance that the creditor's transaction costs increase for bankruptcy claims." *Cassell*, 119 B.R. at 92; see also *General Motors Acceptance Corp.*, 999 F.2d at 68 (the creditor "retains some monitoring and other relational costs in its dealings with the trustee and the bankruptcy court, and it is unclear as an empirical matter whether [the creditor's] net costs in this area increase or decrease with the introduction of a cramdown").

Once again, moreover, this is an issue to take up with the bankruptcy court. If the debtor believes that the market rate assumes costs that the creditor no longer faces, the debtor can offer evidence to that effect and argue for a downward reduction to that rate.

V. Petitioners' Approach Would Have Harmful Consequences.

By denying creditors compensation for risk, return on capital, and administrative costs, petitioners' "formula" would grossly underpay secured creditors in bankruptcy. As we have shown, this undercompensatory "formula" is inconsistent with the text of the Code and this Court's decision in *Rash*. It will

also bring about adverse consequences for borrowers and lenders alike.

Lenders will need to recoup amounts lost in bankruptcy by raising the rates and fees they charge all borrowers:

> [A]ny redistribution afforded debtors as a class as a result of [a] pro-debtor bankruptcy rule will be eliminated by the increased rate creditors will charge initially. The apparent pro-debtor effects of the bankruptcy rule will be eliminated by the increased interest rates charged to debtors as a class. At the same time, debtors who end up in bankruptcy will receive a windfall, as they will reap the rewards of the pro-debtor bankruptcy rule.

Zywicki, *supra*, 19 THURGOOD MARSHALL L. REV. at 263; see also *In re Rash*, 90 F.3d 1036, 1073 n.17 (5th Cir. 1996) (Smith, J., dissenting) (observing that, under the majority's rule appraising collateral based on its foreclosure value, lenders would raise rates, which "might have adverse economic consequences, redistributing wealth from responsible debtors to bad credit risks and thereby forcing good risks out of the credit market"), rev'd, 520 U.S. 953 (1997). In short, everyone will have to pay more for their loans, and borrowers who manage to remain solvent will be penalized as they are forced to subsidize the below-market rates imposed on creditors in cramdown.

The higher loan rates that petitioners' approach would inevitably spawn would make it more difficult for some borrowers to obtain credit at all, putting a damper on consumer spending and increasing pressure on businesses. Companies seeking to obtain capital, hire new employees, or just stay afloat will have to pay higher interest rates to secure needed financing. For some companies, the increases will make it impossible to obtain credit, meaning they will have to forego expansion or cease operations altogether. Others will borrow,

but the higher rates will be more likely to ultimately precipitate default and bankruptcy. Petitioners argue that higher cramdown rates will force some Chapter 13 debtors into Chapter 7 liquidation, but (even if true) this is surely better than forcing a welter of additional corporate and individual borrowers into bankruptcy in the first place, making credit unaffordable for others, and providing still others with loans bearing higher interest rates than they otherwise would. Petitioners' plan to undercompensate creditors in bankruptcy is certain to have all of these effects.

CONCLUSION

The Seventh Circuit's judgment should be affirmed.

Respectfully submitted.

JAMES C. SCHROEDER
Counsel of Record
STUART M. ROZEN
MICHAEL A. SCODRO
Mayer, Brown, Rowe & Maw LLP
190 South LaSalle Street
Chicago, Illinois 60603
(312) 782-0600
Counsel for amici curiae

OCTOBER 2003